Memo

To: **Faculty and Institute of Actuaries Life Board** Date: **28 March 2008**

From: **The Faculty and Institute of Actuaries Tax Working Party**

Copies:

Budget 2008

1 On 12 March 2008, the new Chancellor announced his budget for the financial year 2008-09. From a life insurance perspective, the main point of interest is the Government's general intention to simplify life company taxation. The specific change likely to most affect many firms is the introduction of flat rate capital gains tax for individuals and trustees with no corresponding change to the taxation of life policies. This will lead to a shift in the relative attractiveness of the two forms of investment, probably with a detrimental impact to the insurance sector.

2 In light of this we have produced an article for The Actuary setting out the change and the implications and attach it as an appendix to this note.

3 In the remainder of this memo we cover the areas likely to be of most interest to life actuaries

4 The following includes frequent reference to the concept of "apportionment". In a tax context this refers to the current allocation of income and gains between BLAGAB and Gross Roll Up Business (GRB) using mean non linked reserves over the accounting year. This approach to allocating income and gains clearly is not consistent with the actual allocation to policies and so introduces tax distortions. There are several complicating issues within "apportionment " rules but the above conceptual description should suffice for the purposes of this note.

Capital gains tax

5 Widely publicised changes were proposed to the treatment of capital gains tax in the Pre-Budget Report. One of the unintended implications of the proposals was that it made investment in equity-based life bonds less attractive to many types of investor than direct investment in equity-based mutual funds. Gains on disposal of a mutual fund will be taxed at 18%, although taper relief will no longer apply. This compares to gains within a life bond which would be taxed at 20% after indexation, followed by a further 20% on the gain arising when the higher-rate taxpayer investor disposes of the policy.

6 While there are some classes of investor to whom the changes will not be significant, other classes of investor may be disadvantaged from investing in linked life bonds. This will have implications on future sales of such products, and also on the existing business as investors may seek to cancel such policies to invest in mutual funds. This, in turn, may have implications for the profitability and EEV of life companies who had previously sold these types of product. Groups which include life insurance companies will in most cases also include managers of mutual funds, and these groups will expect to model the impact of the potential move from life bonds to mutual funds.

Financing arrangement funded transfers

7 Following consultation with the life insurance industry in relation to the taxation of financing arrangements such as contingent loans and financial reinsurance, draft legislation will be published in Finance Bill 2008 with effect for periods of account beginning on or after 1 January 2008.

8 Whereas most financial arrangements of this sort are purely commercial, HMRC have expressed concern over arrangements which have provided a tax benefit through the arbitrage of regulatory and accounting treatments. The Treasury has addressed this perceived tax avoidance by replacement of both the existing contingent loans and financial reinsurance tax legislation.

9 Although contingent loan arrangements give rise to immediate surplus on a Peak 1 valuation basis which would otherwise be taxable, relief was given in S83ZA FA 1989 so that tax was only due if the loan principal was transferred from the long-term business to the shareholders' fund. Even then, relief would be available for subsequent repayment of the loan. In contrast, surplus arising from a financial reinsurance of liabilities was taxable, but the subsequent recapture of the liabilities would be allowable for tax giving relief in subsequent periods.

10 The new provisions align the two treatments from 1 January 2008. In neither case will surplus resulting from a financing arrangement be taxable unless it is transferred to the shareholders' fund.

11 Whereas the previous legislation deals with contingent loans and financial reinsurances in relation to the long-term fund of a life company, the new legislation deals only with financing arrangements in relation to non-profit funds where surplus arises which would not have otherwise arisen and is transferred to shareholders. The arrangements also provide corresponding relief for repayments/recaptures of financing arrangements to the extent that surplus has been taxed previously. The new legislation is thus directly targeted at what HMRC perceive as a mischief: the creation of surplus through a financing arrangement and its transfer to shareholders.

12 There are a number of points raised in the consultation process which are to be addressed in draft legislation including:

- A revised definition of "financial reinsurance arrangement" based on the regulatory return definition in IPRU(INS) but with power to amend that definition by regulation. Under the current regime that a financial reinsurance as identified in the FSA return is also a financial reinsurance for tax purposes so that extending the definition of a financial reinsurance for tax purposes is potentially a broadening of the previous regime, albeit in the context of surplus resulting from a financing arrangement not being taxable.
- Provision for apportionment mechanisms for taxable receipts and allowable repayments;
- Amendments to the transfers of business legislation in respect of transfers of financing arrangements as part of a transfer of business with a "just and reasonable" apportionment to parties where not all financing arrangements are transferred or where there is more than one transferee. Changes will also be made where transfers of financing arrangements are made other than by way of an insurance business transfer scheme;

- Transitional relieving provisions for repayments where a contingent loan was to a with-profits fund;
- Further transitional provisions preventing double-taxation.

13 Overall the new regime is a welcome departure from the existing prescriptive contingent loan rules (which by the Treasury's own admission were "seriously flawed") and brings consistency in the tax treatment of financing arrangements. Further work is required to ensure that the legislation applies as intended particularly to reinsurance arrangements.

Taxation of expenses under reinsurance arrangements

14 The 2007 Pre Budget report announced an intention to change the tax treatment of all reassurance arrangements, both internal and external. Following subsequent discussion with the industry there is to be a narrowing of scope of anti avoidance legislation applying to certain types of reinsurance business where all or substantially all of the insurance risk is reinsured but tax benefit of the associated expenses is retained. The revised provisions, which will disallow relief for the associated incurred expenses, will be limited to "fronting arrangements" only.

15 Fronting arrangements are to be defined as the reinsurance of term assurance whereby "all or substantially all of the risk is reinsured with an insurance company…which is connected with the policyholder…or a person obtaining commission". Should the group reinsurance conditions of Sch 19ABA ICTA be met the disallowance of the expenses will not apply.

16 The legislation is to be included in Finance Bill 2008.

17 Amendments are also to be made to S85 FA 1989 to exclude reinsurance receipts other than reinsurance commission, sums calculated by reference to expenses of the cedant company and fronting commission caught by the revised anti avoidance provisions discussed above.

Taxation of Friendly Society business transfers

18 Finance Bill 2008 will contain a change to the transfers of business rules for friendly societies.

19 The tax exemption on "other" business (long-term health and other sickness business) for "old" societies (those registered before 1 June 1973) is more favourable than the exemption available to "new" societies. In FA 2007 the law was changed to allow old societies to transfer their business to a life assurance company and retain the exemption. A similar law will now be passed to allow the transfer of tax exempt business between old and new friendly societies.

Interest apportionment on deposit back arrangements

20 In addition to the changes emerging from the consultation process, a change, labelled as an anti-avoidance measure, is being made to the way in which interest on reinsurance deposits is allocated for deduction in the tax computations of life companies

21 Since 1 January 2000, most interest payable by a life assurance company has been apportioned in the same way as income receivable between the different categories of business recognised for tax purposes. The exception has been interest on late claims which was treated as belonging to the same category as the claims.

22 Regulatory considerations have meant that where large blocks of business are reinsured the funds are frequently deposited back with the cedant. Interest is then paid to the reinsurer.

For commercial reasons, the largest recent such reinsurances have been of annuity business. The change announced here means that from 1 January 2008 interest on such deposits will be allocated to the same "gross roll-up business" category as the annuity business reinsured. In a number of cases, this means that it will increase losses rather than being relieved against income and gains from other life assurance business.

23 This change should really be seen simply as a change to the apportionment regime and not purely as an anti-avoidance measure. Indeed, it could increase the relief available for deposit back reinsurance of other categories of business. The income from the assets is also still subject to apportionment creating a mismatch. This should now be considered further as part of the consultative process.

Impact of FSA Rule waivers and modifications on tax

24 There was some concern that an FSA Rule waiver or modification could in some cases have a significant effect on an insurance company's corporation tax liability. In future, where a waiver which might have a significant tax effect in future periods is granted by the FSA, consideration will be given to making a Treasury order to nullify that tax effect.

Other changes

25 Regarding tax reform, significant work has been carried out on the consultation exercise initiated in May 2006 and many changes have been (or are still being) embedded. There are still, however, some important issues being discussed in 2008/09, most obviously the apportionment rules where to date we have been involved in discussions with the Revenue and industry representatives.

26 The Government will publish a consultation document by the summer as part of its work to reform the taxation of foreign profits.

27 In response to representations from the securitisation industry, some stamp duty and stamp duty reserve tax barriers to securitisation transactions are to be removed.

28 The requirement for overseas insurers to appoint a jointly and severally liable tax representative in the UK for insurance premium tax is to be removed.

29 New regulations come into force on 6 April 2008 regarding the calculation of the exempt capital amount of purchased life annuities. There will no longer be a requirement for HMRC to determine the exempt amount, and more recent tables of mortality are prescribed for insurers to use in calculating the exempt amount.

Further details

30 Full details are available from the web sites of HMRC and HMT at the following addresses:

- http://www.hmrc.gov.uk/budget2008/index.htm
- http://www.hm-treasury.gov.uk/budget/budget_08/bud_bud08_index.cfm

Appendix: CGT article for The Actuary

Capital Gains Tax Reform and the Life Assurance Industry

Matthew Little takes a look at the impact of the recent changes to the taxation of capital gains

On 24th January 2008 the Chancellor, Alistair Darling, reiterated the changes to Capital Gains Tax (CGT) first announced in the Pre-Budget Report on 9 October 2007. In this article we describe the nature of the CGT changes, look at how the taxation environment differs depending upon the choice of investment vehicle and outline the alternatives that were discussed.

So what's changing?

The stated objective for the changes was simplification. They only affect individuals and trusts; not companies and the main points of significance were:

- There will be a single 18% rate of CGT;
- Taper relief will be withdrawn;
- Indexation allowance, which indexes base cost up to April 1998, will also be withdrawn; and
- The changes being effective from 5th April 2008.

What does this mean for the life assurance industry?

In simple terms, the relative position of a higher rate tax payer investing in a bond provided by a life assurance company is likely to have deteriorated when compared to an investment in a Unit Trust or an Open Ended Investment Company (OEIC). This can make a life bond less attractive to an investor. However, it's worth looking at the impact on the life assurance market, the investment market and the offshore investment market to understand this relative impact.

Life bonds

The income and gains from assets backing a life bond are taken into account in the I-E calculation. The expression I-E refers to the basis of taxation where HM Revenue & Customs (HRMC) taxes life assurance business on investment income and chargeable gains (referred to as 'I') less allowable expenses (referred to as 'E'). The income and gains are then taxed as they roll-up during the life of the investment through this calculation.

Once the investment matures, a chargeable events regime kicks in. This, in effect, converts the excess proceeds over initial investment into income. Like any other form of income, it is subject to income tax at rates ranging up to 40% depending, amongst other things, on an investor's marginal rate of income tax. There is a credit of 20% where the roll-up has been taxed in the I-E calculation. Curiously, for higher rate tax payers, the total effective tax rate is only 36% on life bonds rather than 40%. This is because the chargeable gains tax rate of 20% (40% less the credit of 20%) is applied to the investment gain on the policy rather than the gain grossed up for the I-E tax paid by the life company on behalf of the policyholder.

Under current proposals this will not change. Now let's look at other forms of investing.

Authorised investment vehicles

Alternative investment vehicles which an investor may consider include unit trusts and OEICs. Income on authorised investments is declared annually as a dividend to the investor, and recognised in the Income tax return. Here, the investor will pay tax at the appropriate marginal rate, 40% for higher rate tax payers. However, due to the beneficial effect of tax credit receipts on UK dividends it is likely that the marginal rate of tax will be around 25% for equity investments. The income is thus taxed on roll-up during the life of the investment through an investor’s income tax returns.

Once the investment matures, the investor will be subject to CGT on any investment gain. As announced, this will then be taxed at a flat rate of 18% from April 2008. However, the investor will have an annual CGT allowance to negate the full effect of CGT and if used efficiently over a number of years, this allowance can significantly reduce or extinguish the CGT burden.

This is an important consideration as an analysis without this being factored represents an existing layer of over taxation for most policyholders. This is because very few policyholders would be liable to pay CGT on any other investment and therefore rarely use their personal CGT allowance – particularly if they are basic rate tax payers. The personal CGT allowance is not available through the chargeable events regime, and therefore life bonds.

It is also worth considering one other alternative, the offshore bond.

Offshore bonds

An offshore bond is a similar offering to a life bond, except that the investment is managed offshore. This arrangement brings tax benefits and drawbacks. Income, when in the form of dividend or interest may be received net of local withholding tax particularly if the company writing the offshore bond is in a low tax jurisdiction. Other income may be received gross. Tax on gains is then charged when the investor receives the proceeds under the same chargeable events regime as for life bonds. However, there is no credit of 20% since the roll-up has not been taxed in an I-E calculation. The applicable rate of tax is derived as described above for life bonds and related to an investor's marginal rate of income tax.

A key benefit of an offshore bond is that of tax deferral. Tax on income is low, possibly zero, therefore the fund accumulates on preferential terms. However, and a counter to this benefit, offshore bonds do not benefit from a CGT indexation allowance.

There is specific anti-avoidance legislation which applies where investors take funds offshore to avoid tax. This does not currently apply to offshore bonds. The Willoughby[1] case distinguished between tax-avoidance which is acceptable and that which is not. Lord Nolan referred to ‘a course of action designed to conflict with evident intention of Parliament’. The conclusion was that the specific tax regime for chargeable events represented the way in which offshore bonds were intended to be taxed, so that the anti-avoidance legislation did not apply.

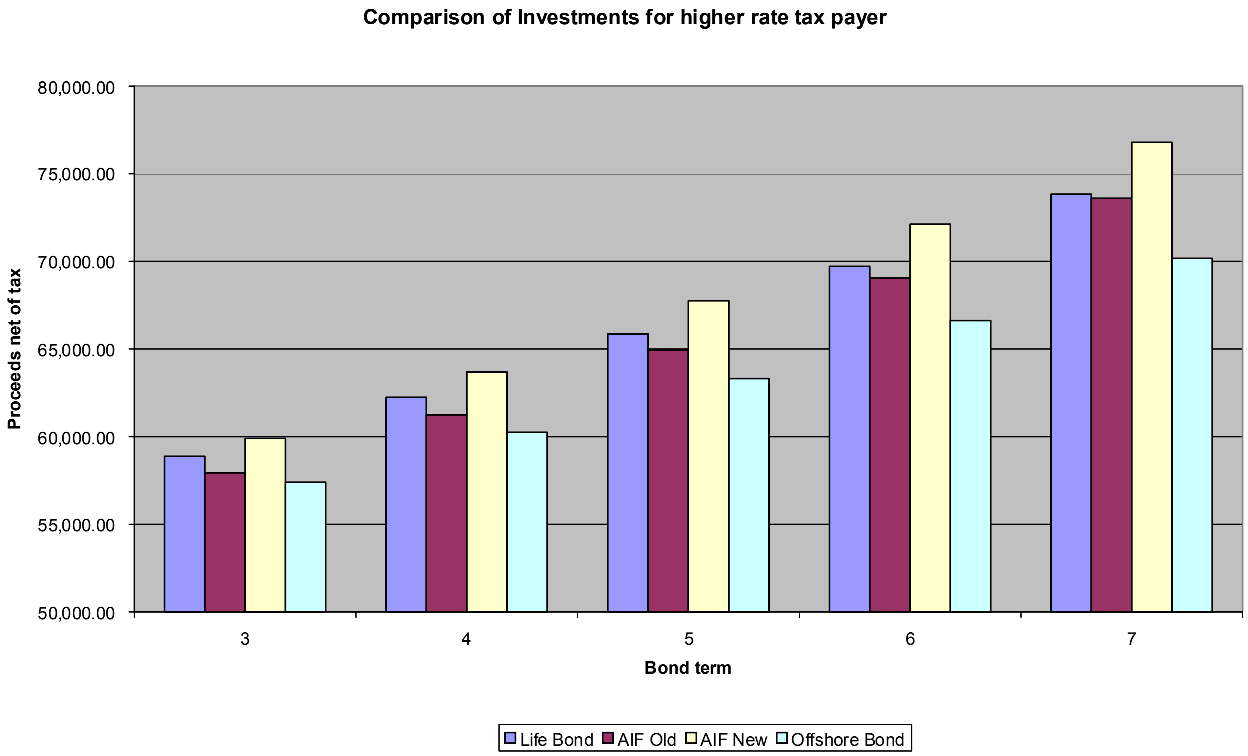
[1] IRC v Willoughby [1997] STC 995

What does this mean for different investors?

The current level of taper relief on direct investment is 0% in the first two years increasing to 40% in year 10 onwards. So in year 10 and beyond any gain was taxable at 24% (60% of 40%) and 12% (60% of 20%) for higher and basic rate taxpayers respectively. So a move to a flat rate of tax of 18% on any gain post April 2008 is:

- much more beneficial for higher rate taxpayers, particularly so in the early years; and
- marginally more beneficial for basic rate taxpayers in the first few years but worse thereafter.

The first chart summarise the relative position of these alternative investments for a higher rate tax payer.

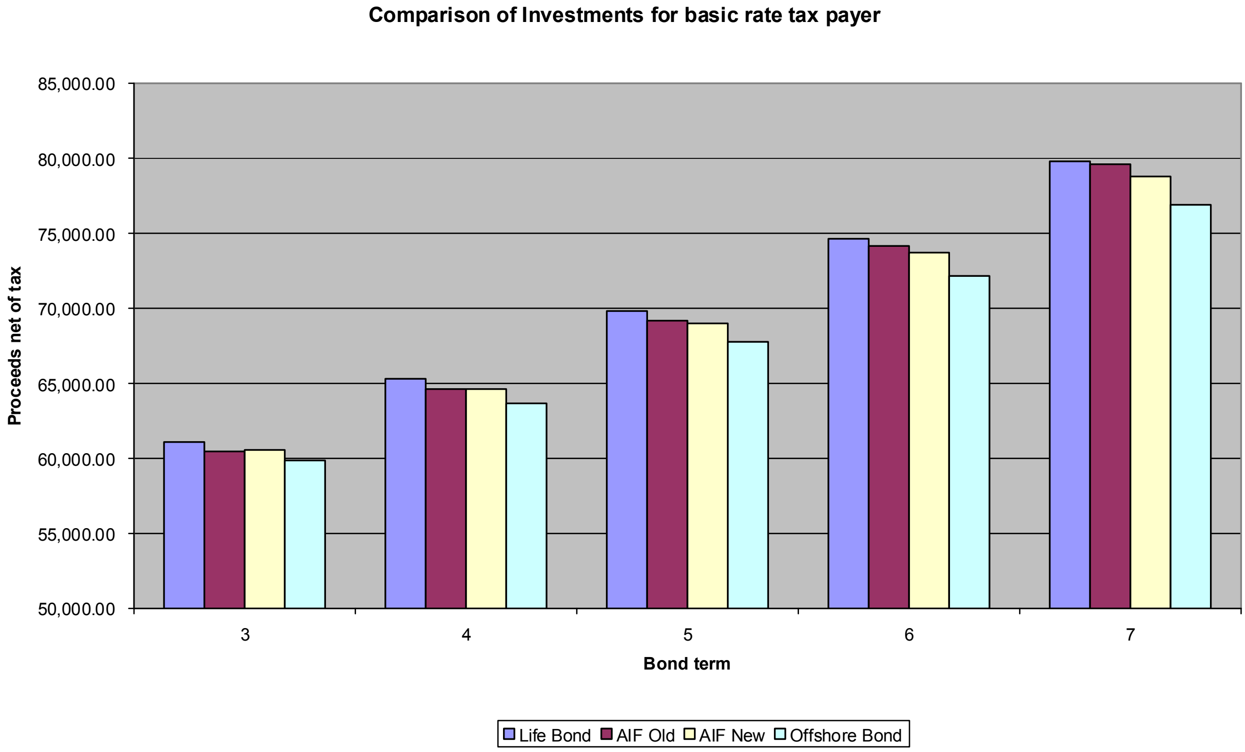


The investments results above assume a £50,000 equity style investment earning a 5.0% real return (plus 2.5% RPI) projected over a 3-7 year period, a 20/80 income/capital split, no relief from the use of the CGT annual allowance (£9,600 in 2008/09) and that the investor is a higher rate tax payer.

Given certain assumptions, it highlights the differential that did exist in the tax regime between authorised investment funds (AIFs) and life bonds. From April 2008, the situation looks very different where the advantage lies firmly with the AIF.

A further thought is the disappointing performance of the offshore bond. Although the offshore bond benefits from the preferential roll-up through tax deferral, it does not benefit from a gains indexation allowance. The CGT indexation allowance is significant within this example.

The second chart summarise the relative position of the alternative investments for a basic rate tax payer.



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Given certain assumptions, it again highlights a differential that did exist in the tax regime between AIFs and life bonds. However, it also highlights the continuing apparent advantage of the life bond.

Please note that any apparent advantage of the life bond can be negated through the management of an investor's annual CGT allowance, when available to be applied to the proceeds of an AIF.

What else has the life industry to offer?

The main concern of the industry is that for a higher rate taxpayer a gain in a life insurance product will be taxed at a cumulative rate of up to 36% while a gain on a direct investment will be taxed at only 18%. However it may be that an investor who is currently a higher rate taxpayer becomes a basic rate taxpayer on exit and will benefit from the change. Such a change in tax status is common in helping to relieve the tax burden of the higher rate tax payer.

There are other specific benefits of investing in a life bond, including:

- They can be written in Trust;
- They are useful for inheritance tax planning, with a benefit provided on death;
- The tax efficiency can be enhanced by taking up to 5% draw-downs each year;

- Switching unit funds is possible without surrendering; other assets classes would necessitate realising gains to switch investments; and

- They can be used as part of a wrapper design;

These additional benefits are now even more important to the future success of the life bond.

What were the alternatives?

Many in the insurance sector voiced concerns about the recently announced CGT changes and the impact on the relative attractiveness of life insurance products compared to other forms of saving, in particular for higher rate taxpayers.

In the above example, it is clear that a large gap now exists when comparing life and investment products for a higher rate taxpayer. A couple of proposals were voiced by the life industry in an attempt to bridge this gap, they were:

- To remove tax on chargeable gains within the life insurer; or

- Change the rate of tax on chargeable events.

The ABI proposed the latter, a reduction to the tax rate on chargeable events to 30% for higher rate tax payers. Thus for life bonds, the effective rate would be 28% rather than 36%. However, the CGT announcements within the budget were a clear signal of events and bring finality to the ABI's recommendation.

This article and previous articles of the Tax Working Party are on our website at www.actuaries.org.uk under life insurance. Our site also has a summary of other events which may affect life company taxation together with links to other relevant websites.

Matthew Little is an Associate at the Financial Services Authority and a member of the Faculty and Institute Tax Working Party. Other members of the working party are Paul Turnbull, Matthew Taylor, Andrew Rendell and Trevor Fannin.